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United States Senate

COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
WASHINGTON, DC 20510-6350

July 8, 2002

The Honorable David M. Walker
Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Walker:

According to the Internal Revenue Service (IRS), the number of tax returns filed by flow-through entities such as partnerships, S corporations, and trusts has increased by 33%, 35%, and 12%, respectively, over the 6-year period from Fiscal Year 1995 through Fiscal Year 2000. During tax year 2000, about \$1 trillion in income was distributed by these entities to individual taxpayers. Current law requires pass-through entities to report the income distributed to taxpayers by filing a Schedule K-1 for each partner, shareholder, or beneficiary, and the taxpayer is required to report the income on his individual tax return.

Compliance with these requirements, however, continues to be a problem. The IRS estimates that up to 15% of such income is not being reported on individual tax returns. Such non-compliance creates obvious fiscal problems for the Federal government. Moreover, it weakens our tax system by rewarding taxpayers who fail to report some or all of their income at the expense of taxpayers who voluntarily comply with the tax laws.

Recently, the IRS has taken actions intended to improve compliance with the requirements for reporting income from flow-through entities. In 2001, the agency began transcribing information from millions of Schedule K-1s. The IRS also began matching the transcribed K-1 information with information on tax returns with the goal of detecting possible non-compliance with reporting requirements. In such cases, the IRS would then contact the taxpayers concerning the apparent under-reporting or non-filing and request additional information.

Because of the potential burden that this process may impose on taxpayers, and especially small business owners, I request that the General Accounting Office (GAO) review the IRS' plans and procedures for the Schedule K-1 matching program and subsequent contacts with taxpayers. In carrying out this work, please provide information on the IRS' K-1 matching program including its goals or expected results, time frames for those results, and resources required. In addition, please identify any technological limitations on the IRS' current ability to match Schedule K-1s with individual tax returns and whether improvements will be necessary to its systems and/or forms to match Schedule K-1s effectively. Finally, please describe the impact that the program will have on small enterprises and their partners, shareholders, and beneficiaries, and assess whether there are steps the IRS could take to minimize that impact.

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Thank you for your assistance on this matter. I would appreciate your keeping my staff apprised of the GAO's progress with periodic briefings during the design and implementation periods of this request. If you have any questions or need additional information, please do not hesitate to contact me or have your staff contact Mark Warren, my Tax Counsel on the Small Business Committee, at 202/224-

Sincerely,

A handwritten signature in black ink, appearing to read "Chris Bond", written in a cursive style.

Christopher S. Bond
Ranking Member